SENATE TAXATION
EXHIBIT NO. 7
DATE 2-8-2013
BILL NO. SB 208

Dan Bucks
577 3rd Street
Helena, MT 59601
February 6, 2013

The Honorable Mike Philips
State Senator
PO Box 200500
Helena, MT 59620-0500

Dear Sen. Philips:

In the hearing on February 5, 2013 on SB 208, committee members referenced the tax treatment of two hypothetical wind energy facilities—one owned by a Montana company and the other by an Irish corporation. You asked me if the Irish-owned facility could gain a tax advantage over the Montana-owned facility if the Irish corporation made a water's edge election. You also asked me if the water's edge election discriminates against Montana companies. My responses to both of these questions were "yes." This letter provides detail behind those responses to aid the understanding of the issues involved in SB 208 and what is at stake for Montana.

Let us begin with the assumption made at the hearing that the original taxable income of both facilities would be $1,000,000. In the case of the Montana corporation, that amount is its full income because it operates only this facility in Montana. The Irish corporation's $1,000,000 income is calculated through the standard method of Montana's corporation law, which is a worldwide combined return. So under these circumstances the two companies are treated equally for state tax purposes—with both paying an annual tax of $67,500.

Assume now that the Irish company has been actively avoiding taxes on 70% of its income at the national level in all the countries in which it operates, including federal taxes in the U.S. It avoids these taxes by shifting income out of countries where it is taxed. The company's accountants advise the Irish corporation to make a water's edge election in Montana to also reduce its Montana corporation tax through these same income-shifting methods. So the company proceeds to do so. While the Irish company's actual, true profits remain the same, where it reports income changes dramatically. When the company makes the water's edge election, its $1 million in Montana taxable income is artificially reduced to $300,000 because its international income shifting practices—which had been effectively disallowed under the worldwide combined return—now come into full play for Montana tax purposes. The net result is that under the water's edge election (with the state tax rate increasing from 6.75% to 7%), the Irish company would pay only $21,000 in Montana tax. So the Irish company ends up with a $46,500 state tax advantage over the Montana company—on top of the even larger federal tax advantage it already enjoys. The following table summarizes these facts:

Filing Election Multinationals Only	Montana Company State Tax	Irish Company State Tax	Irish Company Tax Advantage
Worldwide Combined Reporting	$67,500	$67,500	None
Water's Edge Combined Reporting	$67,500	$21,000	$46,500

This example illustrates two key points:

1. Worldwide combined reporting, because it negates international income shifting, treats a Montana company and a multinational company equally, and
2. A water's edge election that is available only to multinational companies discriminates against the Montana company because the water's edge election allows a multinational to artificially reduce its Montana taxable income through international income shifting.

How could the Irish wind energy corporation engage in income shifting activities? There are multiple methods open to it. A new report by the Congressional Research Service, "Tax Havens: International Tax Avoidance and Evasion," January 23, 2013, summarizes (pp. 8-13) several income shifting techniques. One common method the Irish corporation could use is "earnings stripping." Corporations operating in any economic sector are known to use this method to shift income to financial center tax havens such as Luxembourg or Singapore. They shift income by creating financial transactions with subsidiaries they set up in tax havens to generate artificial tax deductions for interest expense that reduce taxes in the U.S. and other major nations, while leaving income behind in the tax havens in a form that bears little or no tax. Although the U.S. has attempted to curtail this method through laws and rules, this effort is generally considered to have been ineffective.

The Irish corporation could also supplement this first form of income shifting through the infamous "Double Irish/Dutch Sandwich" scheme. The Irish wind energy corporation would transfer intangible assets such as trademarks, proprietary energy management software or patents on specialized equipment to an Irish subsidiary that is treated for tax purposes as if it were in Bermuda. For this purpose we will refer to this as the "pretend Bermuda" subsidiary. The Irish wind energy company would then route royalty payments to its pretend Bermuda subsidiary through a Dutch subsidiary—payments that are tax deductible in the U.S. or elsewhere. The Irish wind energy corporation routes the royalty payments to the pretend Bermuda subsidiary through a Dutch subsidiary in order to gain an exception to the otherwise standard European withholding tax on royalty payments.

Based on discussions at the hearing of known tax sheltering results attained by other corporations, a 70% reduction of taxable income should be within the reach of the hypothetical Irish wind energy corporation through a combination of these and other methods as described in the Congressional Research Service report.

Corporations will likely not engage in these income-shifting schemes merely to reduce their Montana tax liabilities. They do so to avoid larger national level taxes in the countries where they operate including the U.S. However, the state tax reduction created by a water's edge election is simply a bonus.

A worldwide combined report is the only proven and certain method of immunizing Montana from the discrimination against its businesses and the adverse fiscal effects that arise from international income shifting. Worldwide combined reporting works because it disallows all the intercompany transactions among the corporate subsidiaries that generate artificial tax deductions. The methods used by the U.S. government and other nations to address these problems over several decades have been largely ineffective. Looking to the IRS or other federal authority to solve these problems for Montana is futile. Montana should not expose itself to the harmful effects of international income shifting by allowing a water's edge election. SB 208 effectively restores equity and integrity to the Montana corporate tax system.

I hope this information is helpful.

Sincerely,

Dan Bucks

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